Strakosch

South African Currency
and Exchange Problem

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The South African Currency and Exchange Problem

BY

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PREFACE

No apology is needed for the publication of this paper. The problem dealt with is not only of general interest, but its solution on right lines is of such surpassing importance to the well-being of the country that it can only be helpful if everyone who has given earnest thought to the subject submits his conclusions to public scrutiny and criticism.

The pamphlet has its origin in a request from the Prime Minister for an expression of the writer's views on the problem. The main portion of the paper, together with the writer's conclusions, were presented to General Smuts towards the end of last month.

H. STRAKOSCH.

JOHANNESBURG,

5th February, 1920.

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The progress of science and the wonderful development of all means of communication during the last half century have led to a division of labour which went far beyond the boundaries of countries. Nations devoted themselves to the production of goods for which, owing to climatic or other conditions, they were best fitted, relying upon others to supply them with the goods in the production of which they, in turn, excelled. The accumulated wealth of countries in a high state of advancement was devoted to the development of those in a more backward state. The world had become accustomed to this highly complex system of economic interdependence when, in August, 1914, it was overwhelmed by war.

The characteristic economic features of war have accentuated this order of things. A vast proportion of the productive energy of the belligerent nations was withdrawn from normal production owing to the men being needed in the fighting ranks. What remained of their productive energy was insufficient to meet the stupendous requirements for engines of war, the replacements due to destruction, and to provide for the maintenance of national self-existence. The belligerents were thus driven to the necessity of employing the productive energy of other nations to make up the deficiency. The peoples of the world became divided, so to say, into two sections—those who fought and those who produced for the purpose of feeding, clothing and equipping the fighters so that they might live and destroy. The production of goods by the belligerent nations being no longer sufficient to pay for the goods the non-belligerent nations

produced for them, they were compelled to draw upon the accumulated and exchangeable store of wealth they possessed. As that became exhausted they pledged their future production.

When countries cease to produce sufficient goods to meet their own consumption, and when they draw upon the production of other countries to supply the deficiency by pledging their credit (*i.e.*, their future production)—in a word, if their balance of trade is upset—it is then that the Currency and Foreign Exchanges, the most delicate part of the economic machine, are thrown out of gear.

It follows that the problem of Currency and Foreign Exchanges began to arise all over the world immediately the war broke out. No country, belligerent or non-belligerent, South Africa included, could escape it in one form or another. To the superficial observer it did not become apparent for a long time; but it nevertheless existed. So far as the British Empire was concerned, the huge store of accumulated wealth of Great Britain and the vast amount of credit it thus commanded abroad enabled it to draw upon the productive energies of other countries during the long period of hostilities without too visibly disturbing the balance in the Foreign Exchanges.

But when towards the end of March last this method of regulating the Exchanges ceased, and when economic forces were once more allowed to have free play, the Exchanges had to find their own level. Those on countries where a large adverse balance of trade had accumulated moved heavily against England, and the reverse movement developed where the accumulatd balance was in its favour.

Before dealing with the problem as it affects South Africa it is perhaps well, in view of the intimate connection of Currency questions with those of the Foreign Exchanges, briefly to state some of the elemental principles which govern the movement of the latter by quoting from a paper under the title of " Gold and the Foreign Exchanges " which was prepared by the writer early in May, 1919:—

"All trading and financial transactions between one country and another produce obligations to receive or make payments in the other country. The settlement of these involves the sale and purchase of foreign exchange—briefly termed 'exchange'—and thus creates supply and demand.

The *supply* of 'exchange' arises from 'Exports' in the widest sense, which comprise in the main:—

The sale of goods abroad	Visible exports.
The sale of securities abroad	Invisible exports.
The receipt of interest and dividends on foreign securities	
The receipt of profits made abroad ...	
The receipt of freights and insurance money	
The receipt of interest on money lent abroad	
The repayment of money lent abroad ...	
The expenditure of foreigners on travel in the country	

The *demand* for 'exchange' originates from 'Imports' in the widest sense, and springs from converse causes to those producing supply. They are in the main:—

The purchase of goods abroad	Visible imports.
The purchase of securities abroad	Invisible imports.
The payment abroad of interest and dividend on domestic securities held abroad ...	
The profits arising from businesses established in the country but owned by foreigners	
The payment of freights on imports ...	
The payment of insurance premiums (marine and general), less claims	
The repayment of loans contracted abroad...	
The payment of interest on loans contracted abroad	
The expenditure of Nationals on foreign travel	

The price of movements of exchange are governed, as are those of any commodity, by the law of supply and demand. Abundance tends to depress and scarcity to raise its price. 'Exports' and 'Imports' in the widest sense being respectively the source of supply and demand of exchange, an excess of the former at a given moment will produce depreciation, while an excess of the latter will cause appreciation.

Another important (though much less tangible) factor influencing the price movement of exchange, is the faith, or lack of it, obtaining abroad in regard to the financial stability of a country and the soundness of its currency. The flooding of a country with paper money inadequately backed by gold or actual wealth and in excess of its legitimate needs, inevitably produces a severe depreciation in exchange. The movement of the Russian, Austrian and German exchanges during the last two years bear witness to it. It is not enough for currency to be backed by Government securities, for these do not represent actual wealth, but are merely promissory notes redeemable out of the prospective production of wealth of the future."

"The receipts and expenditure arising from the foreign trade of a country (both 'visible' and 'invisible') have—as in the affairs of the individual—to be finally brought into balance.

When, before the war, exports and imports ('visible' and 'invisible') of a gold-standard country did not balance, the surplus or deficiency was settled by the receipt or shipment of gold."

"The gold contained in a British sovereign—123·27447 grains of gold of standard (11-12ths) fineness—when sold abroad at the price fixed by statute in the respective countries will fetch:—

Fr.25·22½ in French currency.
Fl.12·107 in Dutch currency.
Pesetas 25·22½ in Spanish currency.

Fr.25·22½ in Swiss currency.
\$4·8665 in U.S.A. currency.

These prices are generally termed the 'Mint par of exchange.'

To ascertain the prices of exchange at which it becomes profitable to import or export gold, it is necessary to add to or deduct respectively from the 'Mint par of exchange' the cost of shipment, loss of interest, insurance, assay and any other charges incidental to the transfer of gold to the respective countries. Taking these factors into consideration and applying them to the 'Mint par of exchange,' two sets of figures can be constructed which will show the prices of exchange at which it becomes profitable to import and export gold."

"So perfectly balanced was the foreign trade of practically all the great commercial countries before the war that the exchanges moved, with infrequent exceptions, between the narrow margin of the points at which the export and import of gold becomes profitable.

A mere glance at the sources whence supply and demand of exchanges springs will show how finely adjusted every phase of the foreign trade of a country has to be to produce perfect balance, and how even a comparatively small disturbance is capable of throwing the mechanism of exchanges out of gear."

It is well to emphasize the far-reaching importance which the "invisible" foreign trade of a country has upon the movement of exchanges. The error is often committed of concentrating attention upon the published foreign trade figures, which deal merely with the "visible" foreign trade, while insufficient account is taken of the "invisible" imports and exports. The latter, because of their infinitely greater mobility, produce the more immediate and concentrated effect upon the exchanges; shares, public securities, the transference of credit, the settlement of indebtedness and

payment of profits and interest due, all involving the purchase or sale of exchange, move easily and silently in vastly greater volume and at an infinitely more rapid rate than it is possible to move the "visible" foreign trade—*i.e.*, goods.

The idea is not infrequently advanced that the banks and exchange dealers are able to control the movement of exchanges to a material extent. Nothing can be further from the truth. They may be able for short periods to influence such movement to a minor degree by the transfer of balances, by the opening of credits or by the selling of securities, but the volume of supply and demand of exchange arising from the foreign trade of a sub-continent such as South Africa is too great to permit of any combination to successfully control their fundamental movement. It is probably well within the truth to say that the total exchange dealt in to move the "visible" and "invisible" foreign trade of the Union of South Africa during the year 1918 was well over £200,000,000 sterling. There is no single index which reflects more truly the state of a country's foreign trade than the exchanges.

II.

The outward sign that South Africa, too, has a currency problem is the gradual disappearance from circulation of the sovereign. It is disappearing because the gold contained in it will fetch in the world market more than twenty shillings of Union currency, or, in other words, twenty shillings of Union currency is worth less than a sovereign.

What, then, is the value of Union currency? The fact that it is exchangeable for practically an equivalent amount of United Kingdom currency is proof that its value in the world market is equal to that of United Kingdom currency. This parity is maintained in spite of the fact that the latter, measured in gold, has steadily depreciated since the control of the foreign exchange market was abandoned by the Imperial Government in March last. Union currency thus

ERRATA.

Page 9, seventh line from the bottom: Read "Imports" instead of "Exports."

has been, and still is, depreciating concurrently with that of the United Kingdom.

This depreciation remains practically unperceived. Except for the gradual disappearance of the sovereign, it has caused no perceptible interference with South Africa's economic well-being. In other countries similar depreciation has caused a vast amount of disturbance. South Africa's immunity in this regard is undoubtedly due to the peculiar nature of its foreign trade. It is evident from the foreign trade figures of the Union for 1918 that some 75% of its foreign trade was with the United Kingdom, and that the balance was settled in the main not direct but through England. The fact that the exchange on London has remained for years past, and still is, approximately at the par level is in itself, clear evidence that the Union's foreign trade remains in a state of complete balance; otherwise the exchange could not have remained at that level.

On the face of it this is fully borne out by the following tabular statements of the 1918 Foreign Trade of the Union, which cover "invisible" as well as "visible" Imports and Exports. The "visible" foreign trade figures are, of course, ascertainable from official records. The figures given for the "invisible" Imports and Exports must necessarily be approximations, but the bulk of them, viz., the first three items on the Import and the first item on the Export side, are ascertainable with fair accuracy. Reference to the variety of sources whence other "invisible" Imports and Exports spring must lead one to the conclusion that the figures given in the table to cover the items under "Other sources" are reasonable; indeed, if anything, the balancing figure of £5,548,000 for "invisible" Exports appears on the low side. In other words, it is likely that, if a true balance sheet could be drawn, the total Imports in 1918 exceeded the total Exports. The item "Expenditure of Nationals on foreign travel" alone would, in normal times, probably account for fully five million pounds sterling of "invisible" Imports:—

The Union's Foreign Trade in 1918 (Including Gold, Specie and Ships' Stores).

"Visible" Foreign Trade.

(000's omitted.)

Imports from		Exports to	
United Kingdom	£28,517	United Kingdom	£53,512
Rest of the World	22,796	Rest of the World	17,649
Balance of "visible" Exports	19.848		
	£71,161		£71,161

"Invisible" Foreign Trade.

Freights and Marine Insurance	£6,000	Imperial expenditure in the Union	£4,900
Interest on Government Loans	5,200	Other sources (see page 5), say	1,000
Company Dividends ...	9,000	Balance of "visible" Exports	19,848
Other sources (see page 5) balance figure... ...	5.548		
	£25,748		£25,748

One of the effects of the disappearance from circulation of the sovereign is to make it difficult for the banks to maintain adequate cash resources. To meet the position, some of them are understood to have decided to curtail their business, and others have imported gold coin from England at very considerable expense. Both measures are of more than doubtful value

So long as a sovereign is exchangable for more than 20s. in Union currency, so long will it disappear from circulation. History provides us with many instances to show that no legislative or other measure will prevent the disappearance of currency in similar circumstances. Even if it were physically possible to prevent immediate export (which is very doubtful, for, in Europe, where frontiers are easier to guard than in South Africa, such attempts have always failed), it would continue to be withdrawn from

circulation for the purpose of hoarding on the off-chance of export at a later date. Gresham's law—bad money drives out good—has never yet proved to be untrue.

It is safe to predict, therefore, that sovereigns will continue to disappear from circulation. Those of the banks which are importing sovereigns at great expense and are recouping themselves by charging the exporter a higher rate of exchange are merely providing an opportunity for the illicit gold exporter to reap a rich harvest at the expense of the economically most useful section of the community, viz., the producers of exportable commodities.

The policy which the other banks are said to be pursuing of restricting business must, at best, lead to a progressive curtailment of banking facilities, the detrimental effects of which need no emphasis.

Action of a much more positive and comprehensive kind than the mere prohibition of export of coin is therefore needed to put the currency of the country and its credit structure on a safe footing.

The Gold Conference which sat at Pretoria in October last put forward the following proposals:—

(1) (*a*) That the establishment of natural exchanges and of a free market for gold in the Union is desirable.

(*b*) That to this end the establishment of a mint and refinery should proceed with the utmost despatch.

(*c*) That the gold producers be requested to take steps to secure the modification of their selling agreement with the Bank of England so as to permit of termination at short notice.

(*d*) That the embargo on the export of specie from the Union be not continued after the establishment of a mint.

(2) During the course of their investigations the Conference have been impressed with the necessity for one uniform Bank Act for the whole Union, and would impress upon the Government the urgency of the introduction of such a measure in the next session of Parliament, which should provide, *inter alia*, stringent provisions against the inflation of currency.

It is the purpose of these notes to examine whether these proposals are those best calculated to serve the needs of the country.

III.

Before entering upon the discussion it is well to clear the ground by stating that no divergence of opinion can exist that the disappearance of the sovereign from circulation is due to the depreciation of our currency; that this depreciation has proceeded concurrently with that of the United Kingdom; that, generally, to maintain currency at a parity with gold, it must be made freely convertible into gold; and that, to maintain the Foreign Exchanges at their gold par, it is necessary to allow the free export and import of gold, both in the form of coin and bullion; and, finally, that a currency based on this true gold foundation is the soundest and the best.

It is not the purpose of this investigation to call into question any of these well-recognised truths, but to examine whether, in the existing extraordinary world conditions, and having regard to South Africa's economic position and activities in relation to the rest of the world, it can afford to re-establish and maintain its currency on a true gold basis. It is, in other words, the object of these notes to weigh whether the advantages of a true gold standard in the existing economic conditions outweigh the sacrifices its maintenance would entail.

The sovereign can only circulate in the Union without danger of being exported or hoarded if the price which Union currency commands abroad is on a parity with the highest price which gold will fetch in any of the markets of the world, less the expenses of freight, insurance, etc., incidental to its transference. We are accustomed from pre-war days to look for the best market for gold by examining the foreign exchange rates of gold standard countries. But to do so now would be to ignore the existence of powerful economic forces which the war has brought into being.

The war and its aftermath have taught a distrustful world to convert its savings into precious metals rather than employ them in other forms of wealth. The prospects in many countries of a capital levy have much to do with that tendency.

The subjoined table giving data regarding the destination of the South African gold since its free export and sale in the best market has been permitted is highly instructive. It shows that 2,192,078 ozs. (sold for £11,081,900), or 81%, went to the East, the trade and to South Africa, all of which may be regarded as ultimately finding its way into hoards. Only 511,818 ozs. (sold for £2,606,800), or 19%, went to gold standard countries, and may be assumed to have been devoted to currency purposes, although some doubt exists whether the latter figure does not also include some gold which, subsequent to its transference to these countries, went into hoards.

Gold Sales to 19th December, 1919.

	Fine ozs.		Average per fine oz. s.	d.		
East :—						
India	1,385,963	@	100	10	£6,987,600	51·1%
Straits	198,948	@	103	3¾	1,027,800	7·5%
					8,015,400	58·6%

TRADE:—							
England	297,558 @	100 4	1,492,800	10·9%			
Continent	121,580 @	99 10	606,900	4·4%	15·3%		
			10,115,100		73·9%		
SOUTH AFRICA	188,029 @	102 10	966,800		7·1%		
	2,192,078		£11,081,900			81%	
NEW YORK ..	277,159 @	98 6¼	1,365,300		10·0%		
SPAIN	109,268 @	106 3½	580,700		4·2%		
OTHER COUNTRIES	125,391 @	105 4¾	660,800		4·8%		
	511,818		£2,606,800			19%	
						100%	

The East, and especially India, has been the most extensive and persistent buyer. As is well known, the import of gold into India on private account is prohibited. All gold has to be imported under licence, and has to be sold to the Government of India at rates which are periodically fixed by it. These rates have in the past been so regulated as to offer a slight advantage as compared with the price which could be obtained by the shipment of gold to New York or other countries whose exchanges are adverse to England. This advantage usually takes the form of a saving in freight and insurance, the Indian Government taking delivery of the gold in London.

The gold so acquired by the Indian Government is sold in India by tender to the highest bidder. The result of the first sale towards the end of August last was that the sovereign realised 16·8 rupees, while three further sales down to October 20th last realised 15·5, 16·1 and 17 rupees per sovereign. Cable advices from Bombay dated 17th January last show that at the last gold sale gold bullion realised 26·43 rupees per tola fine, 2⅔ tolas being equal to 1 oz. On this basis the sovereign realised 16⅔ rupees. The exchange price of the rupee being now 2s. 4d. of United Kingdom or

Union currency per rupee, the proceeds of the sale of a sovereign at $16\frac{2}{3}$ rupees if remitted to England or South Africa will produce 38s. 9d. in United Kingdom currency, or a premium of $93\frac{3}{4}$%, which compares with just under 26s. per sovereign, or a premium of $29\frac{1}{2}$%, at which price the Indian Government would acquire it at the present price of gold as expressed in the New York exchange, viz., 110s. per fine oz. The difference represents, roughly, the profit which flows into the Indian exchequer.

The world's highest price for the gold contents of a sovereign to-day is, therefore, not 26s. of United Kingdom currency, but 38s. 9d., less the cost of importation into India. Just as any prohibitive measures are incapable, in present-day circumstances, of preventing the disappearance of coin in South Africa, so is it safe to say that no such measures will prevent the illicit importation of sovereigns into India, and that this will continue as long as the profit is high enough to compensate the importer for the expense of importation and for the risk he runs. It is true to say, therefore, that the sovereign could, in these circumstances, only circulate in the Union without danger of exportation or hoarding if the exchange value of Union currency were on a parity with the price which the illicit Indian importer is prepared to pay for gold in South Africa. That price would be above the price of gold as expressed in the New York exchange ($29\frac{1}{2}$% premium) and below the price gold fetches in the Indian Bazaars ($93\frac{3}{4}$% premium). Let us, for argument's sake, suppose that it did not pay the illicit Indian importer to acquire gold at a higher premium than 50%. In that case, it would be necessary for the Union currency to command a premium, in relation to United Kingdom currency, of a trifle over 50%. In other words, £100 of Union currency would have to be capable of purchasing a trifle more than £150 of United Kingdom currency, which is equivalent to saying that the Union exchange on London would have to stand at a little over £150 instead of at the present level of about par.

A compilation of the gold movements into and out of the United States of America, currently published in the press, since March 17th, 1919, down to December 8th last reveal the rather astounding fact that, during that period, there was an excess of exports over imports of gold of approximately $136,000,000, and this in spite of the fact that the New York exchange is supposedly on a gold par and that America's exports of goods of all kinds largely exceed its imports. It is significant, too, that the Secretary to the United States Treasury early in December last asked the Sub-Treasuries to discourage the withdrawal of gold by the public. They were asked to explain to applicants the need of gold as banking reserves and for the payment of trade balances, and the importance of concentrating it in the Reserve Banks.

The high price of gold ruling in the Indian Bazaars seems to furnish the explanation. It also suggests that further heavy withdrawals of gold from the United States are likely to take place, for there is at the present price of the New York exchange a margin of about 60% to compensate the exporter of gold from the United States into India for his expenses, the risks he runs in this illicit traffic, and his profit.

There is no country in the world to-day, except the United States of America, which permits the free export of gold. For South Africa, in the world conditions as they exist to-day, to venture upon a course which would compel it to share alone with the United States of America the burden of supplying the insatiable demand for gold the world over is clearly an experiment of a most hazardous kind. The huge accumulations of gold in the United States Treasury and the Federal Reserve Banks place that country in a position of incomparable superiority to face a heavy drain of gold as compared with the Union of South Africa, which holds a stock of comparatively infinitesimal size, and is only able to satisfy that demand out of its current production. But under the currency system obtaining in the United

States of America, Federal reserve notes are covered by 40% of gold and 60% of trade bills. Upon that basis is built a vast structure of credit. The loss of $40 of gold under that system involves a contraction of credit of $100. It will be appreciated that large withdrawals of gold, connoting as they do a contraction of credit two and a half times as great, may well create a situation of considerable discomfort in America. The contingency—though unlikely—should therefore not be left out of account that the United States of America may be forced by heavy withdrawals of gold to adopt means—perhaps not openly admitted—which would have the effect of making the export of the metal sufficiently difficult to impede the movement. In that case, the burden would fall practically entirely upon South Africa.

IV.

Yet, let it be supposed that it were possible to establish the exchange on London at 150% and to regulate it so as to keep it at all times on a parity with the gold export point (a proposal which—as will be shown later on—is considered incapable of accomplishment), and let us on this supposition visualise the economic effects such a condition of things will bring about.

As gold appreciates and depreciates in terms of United Kingdom currency so will the exchange on London appreciate and depreciate, with the consequence that the exchange, instead of moving within a trifling margin as has hitherto been the case, will be subject to erratic and violent fluctuations. It will probably fluctuate even more violently than does the London exchange on New York, for it will lack the steadying effect which the great volume, the regularity and the great variety of exchange transactions between America and England impart to that exchange. It will, moreover, have to follow more closely the more fitful movements of the price of gold which govern the illicit gold traffic with India, or, if the present embargo on the free

importation of gold into India were removed, the price fluctuations of gold in the Bazaars as long as they are prepared to pay the highest price for it.

It is hardly necessary to dilate on the serious handicap which such violent fluctuations are bound to produce on the foreign trade of the Union. Their paralysing effect on trade and industry is the almost daily topic of the newspapers of Europe and America. The cry the world over is for "stabilisation" of the exchanges. The trader—except in extreme cases—is less concerned about the level at which exchanges rule than about the violence of their fluctuations. These make it difficult and risky for him to fix prices, and for this reason impair his power of competition. They turn into a gamble the legitimate business of the country. The dealer in exchange in these conditions has, for his own protection, to widen the margin between buyers' and sellers' prices of exchange, a burden which, obviously, must fall on the producer and trader and, finally, on the consumer. The violent fluctuations of the exchanges in some European countries are actually leading to a return to a form of barter.

Let us now analyse the effect of raising the exchange to a gold par upon the relationship of Debtor and Creditor in the two countries. An English creditor in respect of money advanced in South Africa will suddenly find that his loan of, say, £10,000 has appreciated, in terms of English currency, to £15,000. His tendency will, obviously, be to call in his loan, convert it into the currency of his own country, and thus reap a rich profit of 50%, for no one in England, or, it is supposed, in South Africa, anticipates that the currency of the United Kingdom will not within a reasonable time—say, within a few years—return once more to a parity with gold.

Under the same supposition, a converse tendency will be produced upon the capitalist in the Union. The high price of the exchange will tempt him to convert his Union currency into United Kingdom currency and loan it out in England in the hope of being able to re-convert it at a

materially lower rate, and, therefore, at a substantial profit, into Union currency when the loan is repaid.

The effect, therefore, of raising the Union currency to a gold par is not only to drain the country of capital loaned by England and other countries whose currencies are depreciated, but also to induce a flow of South African capital to these countries.

That is not only true of short loans in the shape of book debts or bills of exchange, but applies equally to long term loans, such as Government, Municipal and other funded loans. The foreign holder of these securities will sell them on the South African market until the capacity of absorption by South African capital is exhausted and the price of these securities is depressed to a level which destroys the advantage of the exchange. It is unnecessary to emphasise that such a movement must tend seriously to impair the possibility of contracting fresh loans, both in the Union and abroad, and, in any event, must make the terms on which such loans can be contracted more onerous. Similar considerations will induce holders of South African shares held in these countries to sell them in South Africa. The continuous flow of American securities from England to America and of British securities from France to England since the United States dollar has appreciated and the French franc has depreciated is typical of the effect which these exchange movements produce on the international movement of securities.

The economic structure of the Union is largely built upon English and, to some extent, French and other foreign capital, and though South Africa has made wonderful strides, it is still a young country whose accumulated wealth is mainly in a form which does not make it immediately available for the discharge of its foreign obligations or for the absorption of any appreciable amount of its own securities. Its savings have been employed in improving the land, increasing its herds of cattle, building houses, roads and railways.

But South Africa's economic well-being not only demands that the capital invested in the country is retained there; it also requires fresh capital for the development of its vast dormant resources. If it had to rely solely on its own savings, that development would suffer a retardation which would be bound to have serious effects, for the whole economic scheme of the country has become accustomed to an unimpeded, almost continuous, flow of capital from abroad. The very fact that the United Kingdom currency is at a discount in relation to the currencies of countries such as the United States of America, the Argentine and Mexico, where a substantial part of English savings flowed before the war, tends to prevent English capital from migrating to these countries and to foster its investment within the Empire.

To illustrate how a high rate of exchange impedes the flow of capital into the country, let us suppose the Government were to put up fortender another of the Rand mining areas, the equipment of which would cost £1,500,000, of which 80%, or £1,200,000, would be spent in the Union for wages and products of the country, and suppose the exchange on London were at 150% In that case, it would cost the English capitalist £1,800,000 in his own currency to pay for the £1,200,000 which have to be spent in South Africa. He will reason—and rightly so—that by the time the lease area is equipped—in, say, six years' time—and he can expect a return on his investment, the United Kingdom currency will be back to the gold par—*i.e.*, on a parity with the Union currency. His investment would then have involved him in a clear loss of £600,000, by which his enterprise would be penalised through all its existence.

It may be argued that America will fill the gap. It may do so to a trifling extent if it thinks it can secure "real bargains," but it can never supplant England in this respect. One reason for this is that its own vast country, the development of which in pre-war days absorbed not only its own savings, but a substantial portion of those of European countries, offers opportunities for tempting investment on

so large a scale that for years to come there will not be a substantial surplus of American capital available for investment abroad. Besides, America is not accustomed to invest abroad. American bankers, perceiving the danger the high price of their currency in relation to those of the European countries must produce on their exports and, therefore, on their industries, made strenuous efforts to induce American capital to be invested abroad—notably in England—so as to reduce the large excess of America's export and, by that means, to bring the sterling exchange nearer its gold par. It is a well-known fact that their attempts have almost completely failed.

The effect which the raising of the exchange to a gold par has upon contracts should also be mentioned. Suppose a wool farmer has sold his next wool crop under contract for £1,000 to an English buyer, the purchase price being payable in United Kingdom currency, and suppose that since this contract was made the exchange has been raised to 150%. When the wool comes to be delivered and payment is received the £1,000 United Kingdom currency is no longer worth, as it is to-day, approximately £1,000 of Union currency, but only £666. The difference is likely not only to rob the farmer of his profit, but to cause him actual loss.

And that brings us to the vital question of the influence of the exchanges on domestic production generally. The wool farmer or the producer of any other commodity cannot expect to get more for the commodity he exports than the price a similar article will fetch at the point of consumption, less charges for freight, insurance, etc., to that point—that is, in other words, the world price less those charges. The South African producer cannot raise his price in order to counteract the loss he suffers on exchange. If he did, he would be unable to compete with producers in other parts of the globe. His only remedy would be to produce cheaper. If he fails to achieve this, he will be unable to sell his product abroad, and the foreign producer, assisted by the high price of exchange, may well be able to under-sell him in his own market.

The cost of production is largely made up of the cost of labour, so that the cheapening of production in South Africa is, to a very considerable extent, dependent upon a reduction of wages. No one can possibly understand many social phenomena unless he constantly bears in mind the force of habit and social convention. This is strikingly true of the subject of money. The great mass of the people who handle money have no theories or general information whatever on the subject of money. They are guided entirely by custom. To them, it will seem perfectly immaterial whether the £ they handle is worth in the world's market the weight of gold in a sovereign or less. Both the white worker and the native are sure strenuously to resist any attempt to lessen the rate of their pay. That resistance will not slacken even long after the wages they get buy more commodities than they do now. The immediate prospect of unemployment alone may induce them to yield.

Meanwhile, production of every kind is bound to suffer, for the effect of a rise in the exchange upon the selling price of commodities is almost instantaneous, while the reduction in the cost of production must inevitably be a long and laborious process. The want of coincidence of these two factors may well have a most serious effect upon all manner of production in the Union. The farming industry and the newly-established local manufacturing industries, which were able to progress under the protection of high prices engendered by the war, would experience a set-back from which they (and especially the latter) might find it difficult to recover for a great many years. In this connection, attention should be drawn to the anxiety which is felt in England lest some of the continental countries in Europe should be able, owing to the depreciation of their currencies, to produce so cheaply as to materially under-sell English manufacturers.

So far as the gold-mining industry is concerned, the matter would have truly disastrous consequences. The proceedings of the Low Grade Mines Commission, 1919, are

of too recent a date and the overwhelming weight of evidence tendered too well-known to make it necessary to dilate on the subject here. Taking the results for the whole of 1919, thirteen mines worked at a loss. They produced 1,263,500 ounces (£5,370,000 at the standard price) and employed an average of 4,500 whites, who received £1,772,500 in wages, and 35,950 natives, who received £1,400,000. But costs increased during the year and in the quarter ended November last twenty-five mines either worked at a loss or at a profit not exceeding 2s. per ton (taking gold at the standard price). It may fairly be assumed that the disappearance of the gold premium would mean the closing down of all of these within a comparatively short time, which (taking the said quarter's figures as a basis) would mean a reduction in the output of £13,700,000 per annum, and the deprivation of employment to 11,656 whites, earning £4,450,000 per annum, and to 88,164 natives, earning £2,706,000 per annum.

It is perhaps well to make it clear that the raising of the exchange to a gold par will cause the loss of the gold premium on the whole of the output, including that portion which is normally paid in London as dividends, for, with Union currency at a premium, the foreign holder of South African shares will obviously cash his dividends in South Africa and not in London. A saving can only arise in respect of the amounts expended by the mines on purchases abroad, but that saving is comparatively small. The total value of the gold production of the Witwatersrand mines (taken at the standard price) in the year 1918 was about £34,800,000. Of this, only about £5,250,000, or about 15%, was spent abroad.

V.

The most obvious effect of a rise of the exchange to a gold par is that we are enabled to buy goods more cheaply abroad; that cheapening should theoretically correspond closely to the rise in the exchange. More than that, as the

illustration of the wool farmer's case on a previous page shows, the price of home-produced goods is subject to the same influence, and should, therefore, theoretically also fall to the same extent. But that statement needs qualification! It is only correct if it were possible for the home producer to so reduce his cost of production as to balance the fall in price, and that the reduction was sufficiently rapid so as to make it coincide closely with the drop in price of the commodity he produces. It is necessary in this connection to refer to the influence which the volume of production has upon home prices. If a country produces more of an article than it consumes and exports the balance, then that article will command a price at home which is equal to the world price less the expenses of freight, insurance, etc., incidental to its removal to the centre of consumption. If, on the other hand, a country produces less of an article than it consumes and has to import the balance, then that article will command a price which will correspond to the world price *plus* the expenses of taking it from the centre of production to the point of consumption. It will be seen, therefore, that the home producer of articles falling within the latter category is protected to the extent of these expenses. But it is hardly necessary to point out that the home consumer bears the burden of this, and that the beneficial effects of a rise in exchange upon reducing commodity prices at home has to be modified accordingly. If that protection to the home producer is insufficient to make it worth his while to produce, he will cease to do so and the gap will have to be filled by imports.

The drop in prices as a consequence of a rise in the exchange does not merely affect commodities which are produced or imported after that rise has taken place. It, clearly, also affects commodities which have been produced and imported prior to that rise—that is, all accumulated stocks of commodities in the country. Their home selling price will depreciate as rapidly and to the same extent as the exchange appreciates. On the assumption that exchange on

London rises to 150%, £1,500 worth of stock produced or imported before that rise took place will become depreciated to £1,000, simply because it would be possible to replace that stock at the lower figure in the new condition of things. This depreciation, which, in the main, falls on the farming, mercantile and manufacturing community who hold these stocks, may well lead to highly dangerous consequences, in which not only they but also the banks will be involved, for no doubt advances to a material extent have been made by them on such stocks in the ordinary course of their business.

To avert heavy losses which to many may mean disaster, it would only be human for those who hold these stocks to endeavour to hand on some of their loss to the consumer. A powerful incentive is thus created to combine for the purpose of controlling prices. When such combinations have proved their usefulness they are only too likely to be kept in existence long after their primary object has been achieved.

The foregoing remarks cannot pretend to do more than indicate the most palpable effects of a rise in the exchange on commodity prices. It would require a human intellect of an exceptional order to gauge to the full the action and reaction produced by such a movement of exchange. It is well, therefore, to turn to the experience of countries whose exchanges have been, and still are, on a gold par.

Mr. Joseph Kitchin, an eminent London statistician, has prepared for the writer a chart showing the rise of food prices since the outbreak of war up to October last, which is attached to these notes. Attention is drawn to the lines indicating their course in South Africa and in the countries whose exchanges are on a gold par, notably the United States of America, Holland, Switzerland, Sweden and Norway. They strikingly demonstrate that the gold par of exchange is not necessarily a panacea for the ill of rising prices. The United States of America, the greatest producer and exporter of foodstuffs, whose prices are only slightly vitiated by the influence of the cost of freight, etc., has suffered a rise in prices almost double that of South Africa.

It is abundant home production and the high price of freight, insurance, etc., which have kept the rise of prices in South Africa at so low a level as compared with other countries.

To assume that because there has been a rise in prices it must be due to an inflation of currency and credit is to one-sidedly concentrate attention upon the forces affecting the money side of the question and to omit to recognise those affecting production, distribution and consumption. The most conspicuous non-monetary causes, such as diminished efficiency of labour since the war, diminished efficiency of plant due to want of maintenance during the war, taxation, scarcity of shipping due to destruction during the war, deterioration of the productivity of the soil due to neglect during the war, and the necessity of replenishing depleted stocks necessary for the resumption of peace production, are all, obviously, influences of a most potent kind in shaping the course of prices. It is increased production and economy, concurrent with a gradual contraction of currency and credit, that is needed to reduce prices. The multiplication of goods *in itself* produces deflation.

VI.

Having broadly sketched the main influences which a rise of the exchange to a gold par produce upon industry, commerce and finance, we again turn to the consideration of the question whether it is possible to maintain it at that level.

We have seen that the price movement of exchange is primarily governed by the law of supply and demand; that exports and imports in the widest sense (*i.e.*, "visible" and "invisible") are the sources of supply and demand, and that the exchange can only remain on a gold par if exports and imports ("visible" and "invisible") are maintained in a state of complete balance.

We have also seen that the rise of the Union exchange to a gold par produces:—

(*a*) violent fluctuations in the exchanges on all countries which are not on a gold par, seriously jeopardising trade with England, the very country which is the Union's greatest customer and creditor;

(*b*) severe depreciation of the accumulated stocks of the country, seriously affecting producer, trader and banker;

that it fosters:

(1) the withdrawal of loans made by foreigners,

(2) the export of capital for purposes of loans and investments abroad,

(3) the importation of stocks and shares,

(4) the importation of goods from abroad.

all influences in the nature of IMPORTS and all CREATING DEMAND FOR EXCHANGE;

and that it impedes:

(i) importation of capital from abroad,

(ii) home production of every kind,

all influences *reducing* EXPORTS and, therefore, REDUCING THE SUPPLY OF EXCHANGE.

It is hardly necessary to dwell on the magnitude of the amounts which each of the foregoing items is likely to involve. The curtailment of the gold production due to the shutting down of the low-grade mines alone would mean a reduction of exports of £13,700,000 per annum, and it is common knowledge to what an overwhelming extent South African industries and commerce are financed by oversea capital.

The conclusion is irresistible that EXPORTS will be largely diminished and IMPORTS very substantially increased; in other words, that the supply of exchange will be insufficient to meet the demand, and that, consequently, *the exchange*

cannot be maintained on a gold par. To abolish the embargo on the export of specie from the Union in such circumstances must inevitably lead to holders of bank notes demanding their exchange into gold for the purpose of export and, of course, to all gold coin circulating in the country being similarly exported. The serious position which such a run would create for the banks need not be emphasised, nor the difficulties of the country, which would be completely denuded of all circulating media, except perhaps the token coins. It is abundantly clear then that *South Africa cannot, in present world conditions, restore its currency to, and maintain it on, a true gold basis.*

The preceding pages sufficiently indicate how powerful and how varied the reactions are which the raising of the exchange to a gold par produce upon the whole economic organism. The drastic reduction of prices of all stocks in the country, the calling in of loans, the sale of stocks and shares from abroad, the stoppage of the accustomed flow of capital from abroad, and the impeding influence upon all productive industries are the typical forces which make for a crisis. It is the kind of crisis, born of unduly rapid deflation, which statesmen the world over strive to prevent, because of the disastrous effects—economic and political—it is liable to bring in its train. It is gradual deflation, accomplished by increased production of goods and decreased expenditure both by Governments and individuals and accompanied by the gradual and judicious reduction of the circulating media which is aimed at in order to restore sound conditions without exposing the economic organism to the fatal effects of a crisis.

VII.

It is perhaps appropriate to refer to some points which have rather prominently emerged from the public discussion of the question.

The use of the expression "natural exchanges" which has recently been adopted to designate a state of the exchanges commonly described as "gold par" is likely to lead to confusion, especially in the mind of the lay public, and should, therefore, be avoided. It suggests that it is natural for the Union exchange to be on a gold par in the present condition of things, and that its present level has been brought about by artificial means. What is said in the previous pages sufficiently indicates that it would require interference of a most drastic kind to raise it to a parity with gold, and that if it were possible to raise it to that level it could not be maintained at it. The expression "natural," if it is used at all, would more truly describe the state of the exchange as it exists to-day.

One frequently hears it said that South Africa still enjoys a true gold standard. That ceased to be true when the sovereign could be sold abroad for more than 20s. of Union currency and when it became necessary, in consequence, to prohibit the export of gold coin. A currency can only be said to be on a true gold standard if it is not only convertible into gold, but also freely exportable in that form. That presupposes that the foreign exchanges are on a "gold par."

It has been suggested that the embargo on the export of gold from the Union if lifted towards the West and maintained towards India would prevent gold leaving the Union in spite of the high price ruling in India. That, of course, is not so, for the very obvious reason that there would be nothing to prevent the exporter of gold sending it first, say, to the United States of America and then on to India. The somewhat greater charges for freight and insurance would, obviously, not be a deterrent.

It is apparently thought in some quarters that the Union, holding the premier position as a gold producer, is, for that reason, in an exceptional position to maintain its currency and, therefore, its exchange on a gold par. The

fundamental price movements of exchange are governed by supply and demand, which arise respectively from exports and imports. It makes no difference whether the supply of exchange is produced by the export of its gold production or by the export of any other commodity, such as wool, to the same amount.

VIII.

If it is conceded that the true gold standard cannot be maintained in the Union in present world conditions and that the process of restoration to a true gold basis must be a gradual one, means have to be devised to provide the country with a currency to tide over this period. That currency must be of a kind which will freely circulate without danger of being withdrawn for the purpose of export and hoarding. It should inspire the utmost confidence, and should, therefore, have behind it a backing fully equal to its face value. The conditions under which it is issued must, moreover, be so framed as to provide thoroughly effective safeguards against an over-issue. These conditions seem best fulfilled by a scheme framed broadly on the following lines:—

Legislation should be introduced authorising the Government to create what may be termed "Treasury Gold Certificates." The conditions of their issue should provide that there shall always be deposited in the vaults of the Treasury an amount of gold coin or bullion which, taken at the standard price, is sufficient to redeem the whole outstanding issue. It will be appreciated that these notes will have a backing behind them which, taken at the current price of gold, largely exceeds their face value, and that this excess will only disappear when gold has once more receded to the standard price. With the present gold premium of, say, 30%, it would require an expenditure of £130 to acquire the gold backing necessary for the issue of £100 of notes

under the proposed scheme. The danger of over-issuing these notes clearly does not exist; indeed the proposal errs, if anything, on the side of unduly restricting the creation of currency to meet the legitimate requirements of a possible trade expansion.

These Treasury Gold Certificates should be made convertible into gold, but the Government should be relieved of that obligation so long as gold commands a price in the world's markets which exceeds the standard price. When that point is reached there will be immediately available in the vaults of the Treasury sufficient gold to redeem the whole of the outstanding notes. The effect of the scheme is to make the Government, so to say, the guardian of the country's gold currency during a time in which its free circulation is endangered by the extraordinary world conditions.

A note issue of this kind has nothing whatever in common with the note issues of the vast majority of European countries. These are mostly of a purely fiduciary character, there being (except in rare cases) no backing behind them other than the credit of the State, and they are, therefore, liable to be over-issued. Their primary object of serving monetary needs is forgotten, and their issue is resorted to as a fiscal measure for borrowing purposes.

The gold needed for the backing of the suggested issue of Treasury Gold Certificates should easily and rapidly flow to the vaults of the Treasury. The banks of the Union, who hold by far the largest proportion of the gold coin in the country, should be especially anxious to convert their holding into these Gold Certificates. In that form their reserves are not liable to be drained for purposes of export and hoarding, and the banks would, therefore, be saved the necessity of replenishing them at very great expense or of keeping them at their proper level by the curtailment of their business. The gold coin held by the law-abiding public —that is, the coin which is not withdrawn from circulation

for purposes of export and hoarding—would in the natural course of things flow to the banks, and thence to the Treasury vaults in exchange for these Gold Certificates.

The gold coin available in the country and in the course of importation should go a long way to provide the requisite volume of currency. Any deficiency will necessarily have to be imported by the banks. The burden of doing so would be in the nature of a final sacrifice.

IX.

A perusal of the Banking Laws of the Union, of which there are no less than four in number, cannot help but impress one with the desirability of their revision and unification. They are more or less antiquated and hardly adequate to meet the needs of a country whose agriculture, industries and commerce are rapidly growing. The country has reached a stage of economic development where special care is needed to overhaul and modernise its credit system so as to help forward its progress on sound lines and, at the same time, shield it from the ever-recurring excesses produced by the failings of human nature. Credit is a vital element in all healthy economic life and credit is based upon confidence. To secure an organisation of credit by which confidence is firmly established and credit maintained under all circumstances and conditions is the goal to be aimed at.

No one can study the experience of the great commercial nations without being impressed by the high efficiency of their credit organisations. The work of the great central banking institutions in piloting them through prosperity and adversity is especially noteworthy. The experience of these countries, with their centuries of economic life, where every financial problem receives careful and intelligent consideration and where vast financial transactions are constantly taking place, should certainly be suggestive and valuable to

us. If we are to profit by their experience, the question of establishing a Central Reserve Bank for the Union should receive the closest attention.

It would be going far beyond the scope of these notes to attempt to examine the problem in its many bearings. The subject is vast, and it involves so many collateral questions which are intricate and complex that a special study by a set of highly skilled and experienced men is needed to decide what particular system is especially adapted to meet the needs of the Union.

The study the writer has been able to give to the subject has led him to the conclusion that the system which will probably be found to be best suited to this country is one which in its fundamental principles follows that of the Federal Reserve System of the United States of America. Many of the cumbrous parts of the system which were introduced so as to meet the peculiar conditions of the American banking organisation and the country generally would naturally fall away, and variations may have to be introduced to meet special conditions particular to this country.

It is broadly suggested that a Central Reserve Bank be established in the Union, the capital of which is to be provided from private funds, the Government having no interest in the shares of the bank. In view of the important functions which the bank will have to perform in sustaining the credit of the country, the Board should consist of a set of experienced men drawn from all sections of the economic life of the country. The appointment of the Governor and Deputy-Governor should be subject to the approval of the Government.

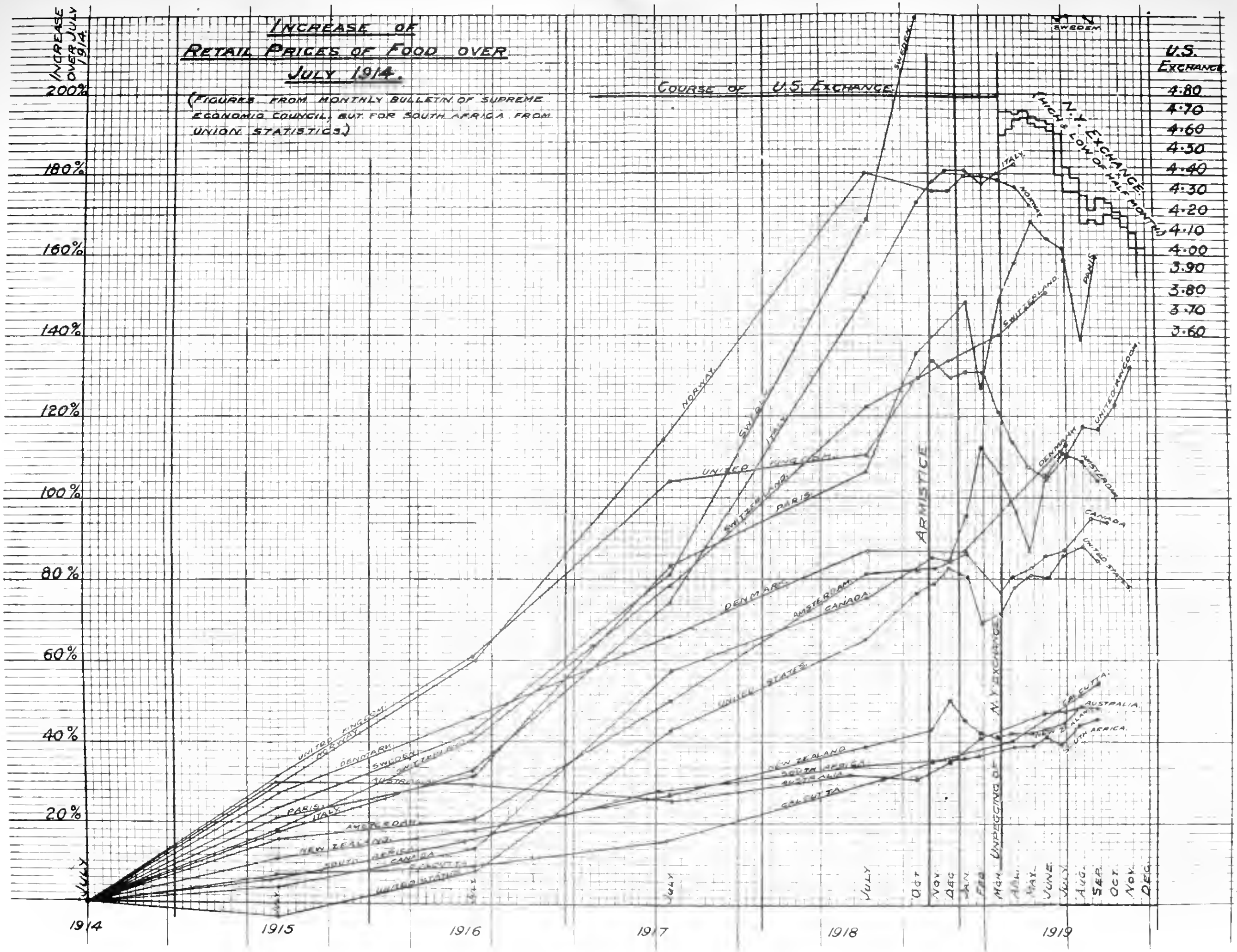
Its business should be to act as the Banker of the Banks. It should not be, in any general sense, a competitor of the commercial banks. Their cash reserves would, to a large extent, be deposited with it, and only in times of emergency would it take an active part in the country's

business. It would re-discount the bankable bills of the commercial banks in times of stress, and thus transform into a reserve an asset which otherwise has no value in this regard. To protect its own reserves, it would regulate the general tendency of discount and money rates and, by that means, influence the financial policy of the commercial banks and, through them, of the country generally.

It must have the monopoly of issuing bank notes. These should be covered by a minimum of 40% in specie or Treasury Gold Certificates and by 60% in genuine commercial Bills of Exchange of not more than 90 days' currency and bearing three signatures. These bank notes will take the place of the bank notes now current, and will be convertible into Treasury Gold Certificates. The liabilities of the Central Reserve Bank in respect of deposits should be covered by at least 35% in specie or Treasury Gold Certificates and by 65% in similar Bills of Exchange.

Provision should also be made for the commercial banks to maintain a minimum ratio of cash to liabilities of 15%, a substantial proportion of which should be held as a deposit in the Central Reserve Bank.

The Federal Reserve System of America has been modelled, to a very considerable extent, on the lines of the old-established systems of the principal continental countries of Europe, and has stood the test of adversity by successfully seeing the country through the difficult times of the great war. It is doubtful whether a better model can be found.


INCREASE OF
RETAIL PRICES OF FOOD OVER
JULY 1914.
(FIGURES FROM MONTHLY BULLETIN OF SUPREME ECONOMIC COUNCIL, BUT FOR SOUTH AFRICA FROM UNION STATISTICS.)
INCREASE OVER JULY 1914.
COURSE OF U.S. EXCHANGE
U.S. EXCHANGE
N.Y. EXCHANGE (HIGH & LOW OF HALF MONTH)
ARMISTICE
UNPEGGING OF N.Y. EXCHANGE
200%
180%
160%
140%
120%
100%
80%
60%
40%
20%
4.80
4.70
4.60
4.50
4.40
4.30
4.20
4.10
4.00
3.90
3.80
3.70
3.60
1914
1915
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1918
1919
JULY
OCT
NOV
DEC
JAN
FEB
MCH
APL
MAY
JUNE
JULY
AUG.
SEP.
OCT.
NOV.
DEC.
SWEDEN
NORWAY
ITALY
UNITED KINGDOM
SWITZERLAND
PARIS
DENMARK
AMSTERDAM
CANADA
UNITED STATES
NEW ZEALAND
SOUTH AFRICA
AUSTRALIA
CALCUTTA